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THE CASE FOR HEAVIER CAPITAL GAINS TAXATION

by

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ABSTRACT: THE CASE FOR HEAVIER CAPITAL GAINS TAXATION

Unless tax policy is evaluated not only from a short-run macroeconomic fiscal policy standpoint but also from a longer-run microeconomic policy standpoint that considers taxation's effects upon equity and resource allocation efficiency, federal taxation's unnecessary excess burden will become no lighter and may grow heavier. This paper attempts to redress the balance of the current federal personal and corporate income tax reform discussion, which has paid minimal attention to the case for heavier capital gains taxation. It reviews the capital gains tax policy literature, argues that present tax law's special treatment of capital gains and losses (compared with its treatment of ordinary income and loss) is not justified, and offers specific recommendations for taxing capital gains more heavily.

Special treatment is horizontally and vertically inequitable. It is a major cause of income tax law complexity. And it misallocates the resources invested in new physical capital, by distorting taxpayers' financial decisions and disrupting movements of financial capital, more seriously than heavier capital gains taxation would. Capital gains tax reform should decrease the differential between the effective tax rates on capital gains and ordinary income, and narrow the legal definition of capital assets qualifying for special treatment.

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When inflation threatens, most economic discussion about taxation debates the necessity of a tax increase. Are inflationary pressures really significant? Has monetary policy been used as much as deemed advisable to raise interest rates and discourage private spending? Has government spending been cut as much as feasible given war, or social needs or pressures? How soon will any particular anti-inflationary action actually affect aggregate demand -- will it take effect only after increased real output of goods and services has matched the initially unsatisfiable demand, the inflationary problem has eased or ended, and the economy is in danger of a recession?

Conversely, in recession most tax discussions concern analogous questions about the need for a tax cut. In either case, such uncertainties may prevent discussion of a crucial question: which taxes should be changed, and how? Yet the question "Which tax changes?" is far from trivial. At least four implications demand consideration: Which tax changes would Congress most likely adopt in time to do the job required? Which would deal most effectively with the immediate short-run problem of inflation or recession? Which would be most desirable for the economy's longer-run efficiency? Which would be most equitable?

Prompt congressional action is so imperative that the first question may appear all-important; answers to the others, while interesting, may not seem important enough to affect significantly the tax requests to be made of Congress. But as important as speed of enactment is, the relevance of a short-run tax policy's short-run effectiveness against the problem at hand -- the size and speed of its impact -- should be obvious also.[1] And a short-run tax policy's longer-run consequences for equity and economic efficiency are at least equally important.

In the lengthy pre-enactment discussion of the 1964 tax cut, the notion that "tax reform" proposals should be divorced from tax proposals designed to fight inflation (or recession) was advanced frequently. And the belief that mixing "tax reform" and fiscal policy only delays enactment of the fiscal policy is probably a major reason for former President Johnson's choosing to fight inflation with an across-the-board ten percent income tax surtax rather than with a set of specific changes in particular personal and corporate income tax provisions and rates, and for President Nixon's desire to separate surtax extension legislation from tax reform legislation. But separation of fiscal policy from "tax reform" proposals may prevent any improvement in and might even steadily

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[1]Consider the March 1966 increase in automobile, telephone, and teletypewriter excises, to fight an inflation largely concentrated in heavy investment goods, food, and medical and other consumer services. The telephone and teletypewriter tax increases appear particularly poor choices, since these services are produced by a regulated public utility industry, probably under decreasing average unit cost conditions. The increased tax on telephone calls presumably decreased demand below what it otherwise would have been, increased the average cost of each telephone call made (by spreading the high fixed overhead cost over fewer calls), and released virtually no resources for use elsewhere in the economy. That these tax changes were microeconomically inefficient seems clear. But should an optimal tax policy strive for microeconomic neutrality, or should it be designed to reduce demand for specific commodities where inflationary pressures are most severe?

worsen the tax structure's effects upon both equity and the economy's allocative efficiency. Desirable tax changes not required by short-run fiscal policy considerations will seldom be considered seriously. And if short-run macroeconomic problems are met by tax changes designed without regard for their long-run microeconomic impact, the unnecessary burden of federal taxation will become no lighter, and may grow heavier as various stages in succeeding business cycles pass into history.

Fiscal policy aside, there is an enormous need for federal income tax reform designed to improve horizontal and vertical equity, to simplify the tax law and the government's task of tax administration and the taxpayer's task of tax compliance, and to remove tax distortions of the private economy's allocation of resources.[1] Tax changes for any purpose should generally be designed to broaden the tax base and reduce tax rates, by eliminating and simplifying special exclusions, exemptions, and deductions. Yet effective political pressure for more equitable, microeconomically neutral, and uncomplicated taxation simply does not exist, at least as compared with the aggregate pressures for special tax

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[1] See Pechman, Federal Tax Policy (1966); Goode, The Individual Income Tax (1964); Stern, The Great Treasury Raid (1964); Eisenstein, Ideologies of Taxation (1961); and Okner, Income Distribution and the Federal Income Tax (1966). For a more neutral discussion, see U. S. Congress, Joint Economic Committee, The Federal Revenue System: Facts and Problems 1964. For a discussion of proposed Canadian tax reforms applied to the United States, see Holland (editor), "A Symposium on the Report of the Royal Commission on Taxation (Canada, 1966) -- The Carter Commission" (1969).

privilege. Consider the numerous compromises in the Kennedy Administration's 1962 tax reform proposals between the equity, microeconomic neutrality, and tax law simplicity advantages of a broad income tax base and the political advantages of catering to special taxpayer interests.[1] Consider the vigor with which the 88th Congress ignored or decimated the mildest of those compromise tax reform proposals.[2] Finally, consider the timidity of the reform proposals which currently have some chance of passage, such as the suggestion to levy a minimum income tax on persons receiving large amounts of untaxed or lightly taxed income, instead of eliminating or even revising the tax law provisions which give rise to such income.

Such considerations, which have resulted in the existing chaotic tax structure, show that the need to identify the tax structure's most disadvantageous deformities, to design appropriate changes for possible inclusion in future tax bills, and to advocate with sufficient vigor the most pressing of these changes, remains unsatisfied.

Perhaps the most important structural defect in the federal income tax is its special favorable treatment for long term capital gains, in

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[1] U. S. President, 1961-1963 (Kennedy), President's 1963 Tax Message.

[2] U. S. Congress, House Committee on Ways and Means, Legislative History of H. R. 8363, 88th Congress, The Revenue Act of 1964, Public Law 88-272 (1966). Also see Pechman, "Individual Income Tax Provisions of the Revenue Act of 1964" (1965).

comparison with its treatment of ordinary income.[1] Long term gains, primarily stock market and real estate profits (on assets held more than six months) are taxed by including only one-half the gain in ordinary income. Moreover, the effective tax rate on the included half of the long term gain may not exceed 50 percent -- that is, 25 percent of the entire gain. Short term gains, gains on assets held less than six months, are considered "speculative profits" and are fully included in and taxed as ordinary income.[2]

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[1] The most recent comprehensive discussion of capital gains taxation is David, Alternative Approaches to Capital Gain Taxation (1968). Also see Folsom, The Full Inclusion of Capital Gains and Losses in the Taxable Income of Individuals (1964); Seltzer, The Nature and Tax Treatment of Capital Gains and Losses (1951); and U. S. Treasury Department, Tax Advisory Staff of the Treasury, Federal Income Tax Treatment of Capital Gains and Losses (1951).

For a discussion of proposals to tax capital gains as ordinary income in Canada, see Break, "Integration of Corporate and Personal Income Taxes" (1969); Slitor, "The Carter Proposals on Capital Gains: Economic Effects and Policy Implications for the United States" (1969); and Harberger, "In Defense of Carter: A Personal Overview" (1969), pp. 167-169.

[2] Long term losses are subtracted from long term gains, short term losses from short term gains, to get net long and net short term gains. If there is a net long term loss it is subtracted from the net short term gain; if there is a net short term loss, it is subtracted from the net long term gain. Up to $1,000 of any overall capital loss is deducted from ordinary income; any undeductible excess is carried forward to future tax years. A corporation's long term gains are taxed either at the bottom bracket ordinary income tax rate of 22 percent, or else at 25 percent; its short term gains are taxed as ordinary income. Its capital losses are treated the same as an individual's, except that they can never be deducted from ordinary income. The precise definition of capital gain and loss is a major issue of a later lection of this paper.

In addition, gains unrealized at the taxpayer's death never are taxed at all. The heir who sells the property uses the value at the decedent's death for his "cost" in computing his gain or loss. Thus all gain accrued by the decedent escapes taxation.

This paper contends simply that the differential between present tax law's especially favorable treatment of capital gains and its treatment of ordinary income -- effective tax rates on gains are generally less than half the rates on ordinary income -- is far too great. In any future tax increases, capital gains taxes should go up more, proportionately, than any increase in levies on ordinary income. In any future tax cuts, capital gains taxes should not participate. Eventually, the distinction between capital gains and ordinary income should disappear.

Special favorable tax treatment of capital gains (and losses) is subject to criticism on three counts. First, such treatment disrupts the horizontal equity and vertical progressivity of the income tax. Second, it is the major contributor to the chaotic complexity of federal income tax law. Third, it misallocates the resources invested in new physical capital, by distorting taxpayers' financial decisions and disrupting movements of financial capital, more seriously than heavier capital gains taxation would.

EQUITY CONSIDERATIONS

Society's struggle for an equitable tax structure is unending. Even if government were removed from political pressures and were inclined to be objectively dispassionate, its search for fairness in taxation would founder, first upon its inability to make meaningful interpersonal utility comparisons, and then upon the lack of any obvious rationale for assigning utility reductions among taxpayers. Given the inevitable difficulty that decreasing one man's tax burden requires increasing someone else's, the lack of consensus about the operational meaning of equity is hardly surprising.

Hence we dispute whether the best index of taxable welfare is wealth, consumption, or income; the degree (if any) to which levies upon any of these bases should be progressive; and the allowances due for special considerations such as family size and medical expenses. Such practical questions need debating. But our use of an income tax, for example, need not and should not involve quasi-metaphysical definitions of the word "income." We are at liberty to define "income for tax purposes" pragmatically, in order to obtain an index of relative economic welfare among taxpayers such that the relative distribution among citizens of the burdens from their collective use of scarce economic resources is as reasonable as feasible.

What constitutes a reasonable relative distribution of tax burdens is a value judgment, of course, and debatable.[1] Nevertheless, much

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[1] See Blum and Kalven, The Uneasy Case for Progressive Taxation (1953, 1963).

discussion of the equity of capital gains tax policy studiously avoids this issue. The standard argument against heavier gains taxation is that it would be inequitable because "capital gains" are not "income." But whether or not capital gains really are income is irrelevant to the equity of capital gains tax policy -- irrelevant even though capital gains are taxed under an "income" tax. The equity of taxing capital gains -- under an income tax or other levy -- depends solely upon whether doing so "improves" or "worsens" the distribution of relative tax burdens.[1] Using this criterion, consider the equity of the arguments commonly given in support of special treatment for capital gains.

Equity Versus Gains Taxation

A taxpayer can benefit from owning a productive asset either by holding it and receiving the stream of receipts it produces, or by selling it to receive the capitalized value of its expected future stream of receipts. A change in this capitalized value (excluding expected depreciation) is a capital gain or loss. Aside from changes in the interest rate at which the expected stream of receipts is capitalized, or changes in the price level, a capital gain or loss will occur only if the asset becomes more or less productive (in comparison with other assets) so that its expected future stream of receipts increases or decreases (relative to other assets). Thus "pure" capital gains and losses are a manifestation of changes in income.

Capital gains as income. The argument that even though capital gains

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[1] Turvey, "Equity and a Capital Gains Tax" (1960).

result from changes in expected future income, they do not constitute income, and therefore are not properly subject to taxation at ordinary income tax rates, traditionally is illustrated with an orchard.

> Capital and income are regarded by most investors as quite distinct, and fluctuations in the value of one's capital are unrelated to one's income. . . . The crop of apples is clearly income, but the growth in the size of the tree is not; it cannot be eaten or sold, except as firewood. . . . If a grown apple orchard is disposed of and the proceeds reinvested in a pear orchard of equal value, there would still seem to be no final realization in the form of income. Capital, including the appreciation on it, has been changed from one form to another, but it has at all times remained as capital distinct from income.[1]

In other words, taxing a capital gain (either when it occurs or when the asset is sold) as well as the increased income which that gain represents, is double taxation.[2]

This double taxation argument, carried to its logical conclusion, would exempt all saving from taxation -- making consumption, rather than total income (consumption and saving), the taxable index of relative taxpayer welfare. Taxing a capital gain as well as taxing the flow of earnings that gain represents is no less equitable than taxing a salary which is saved and invested and then taxing that investment's earnings as well.

An income levy on consumption and saving <u>is</u> justified, on the assumption that a taxpayer able to save has more taxpaying ability than

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[1]Smith, <u>Federal Tax Reform</u> (1961), p. 122.

[2]Wallich, "Taxation of Capital Gains in the Light of Recent Economic Developments" (June 1965), pp. 139-140.

another taxpayer spending an equal amount on consumption but unable to save, _and_ that the former's greater taxpaying ability is inadequately measured by the future income earned by his invested savings. That is, adequacy requires levying on the original saving.

> The individual income tax applies to the entire income of an individual whether it is spent or saved. Some have argued that the income tax is unfair to those who save because it applies both to the income which gives rise to the saving and to the income produced by the saving process. But almost all economists now agree that, on equity grounds, this double taxation argument does not have much merit. At any particular point in time, an individual has the option to make a new decision to spend or save from the income that is left to him after tax. If he decides to save the income, he does not necessarily incur a new tax. It is only if the saving is actually invested in an income producing asset that new income is generated and this new income is, of course, subject to additional tax.[1]

If taxable income is to be an index of relative economic welfare among taxpayers, defining it to include capital gains (and to deduct capital losses) simply implies that the farmer whose orchard trees grow and mature has more taxpaying ability than the farmer whose trees are stunted by a cold snap, that the latter has more taxpaying ability than a third farmer whose trees are blown down by a hurricane, _and_ that their relative taxpaying abilities are inadequately measured by the differences in the current income earned by their respective properties. If this implication is unreasonable, it is no more unreasonable than taxing a crop saved and invested to set out a new orchard, as well as taxing the new orchard's crop.

[1] Pechman, _Federal Tax Policy_, pp. 61-62. Also see Musgrave, _The Theory of Public Finance_ (1959), pp. 161-164; and David, _Alternative Approaches_, p. 46.

Rather than baldly asserting that capital gains are not income, recent defenses of special favorable tax treatment of capital gains have argued that capital gains are not income equitably subject to ordinary income taxation because present national income accounting concepts exclude them, or else because they are usually "illusory" -- caused by changes in the capitalization rate (interest rate) used to discount expected streams of future income, or by inflation.

National income accounting concepts. The argument that capital gains are not income and should not be subject to ordinary income taxation because they are not included in "national income" has been advanced by Henry C. Wallich.[1] But if "taxable income" is to indicate relative ability to pay taxes, national income accounting concepts are utterly irrelevant.

> There is no reason to assume that the concept of income best suited to the goals of national income accounting is the same as that best suited to the objectives of the income tax. . . . The issues can only be confused by relying on a concept developed for one endeavor as a reason for modifying another concept developed for a wholly different purpose.[2]

The national income accounts are designed primarily to measure the aggregate U. S. income from current production of goods and services. Thus the "national income" is defined arbitrarily to exclude inventory profits, transfer payments (including interest on government debt), gifts and bequests, and both short and long term capital gains, among other items.

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[1] Wallich, "Taxation of Capital Gains," pp. 136-137.

[2] Blum, "Taxation of Capital Gains in the Light of Recent Economic Developments -- some Observations" (December 1965), pp. 431, 432. Also see Musgrave, Public Finance, p. 169.

At least some of these are reasonable inclusions in a "taxable income" index of relative taxpaying capacity. The issue is not whether the sum of microeconomic incomes equals macroeconomic income, as Wallich argues.[1] The issue is relative tax burdens.

Capitalization rate changes.[2] Assuming that an asset's expected future stream of earnings remains constant, the asset's capital value and the rate of return it earns vary inversely. Thus as bond prices rise, bond yields fall; as equity (stock) prices rise, the earnings/price ratio falls (or, more popularly, the price/earnings ratio rises).

The argument that capital gains caused by a decline in the (interest) rate at which future income is capitalized are "illusory," not income properly subject to income taxation, maintains that since the interest rate decline does not change the taxpayer's earnings from his property, he is no better off and should not be taxed. Similarly, if interest rates rise so that the capitalized value of the asset falls, the taxpayer's capital loss should not be deductible because he is no worse off. This argument really is a more sophisticated version of the "changes in the value of capital are not income" argument. Both assume that income tax paying ability arises

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[1] Wallich, "Rejoinder [to Blum]" (December 1965), p. 437. Here Wallich does note the national income accounts' inventory profit adjustment. It, however, unlike the capital gain exclusion from national income, is "not important," using some not specified criterion. Incidentally, for a view (with supporting bibliography) that macroeconomic "national income" and also "national output" *should* include capital gains, see Campbell, *Capital Gains, Economic Growth, and the Distribution of Income, 1897-1956* (1964), pp. 22-28, 55-61, 67-73, 236-327.

[2] For a more extended discussion of capital gains and losses due to interest rate changes, see Seltzer, pp. 93-98; David, *Alternative Approaches*, pp. 55-56.

only after the taxpayer has maintained a sufficient capital value to provide a constant absolute stream of money income from that capital.

Musgrave asserts that "the proposition that capital gains which reflect a decline in the rate of interest should not be . . . taxable . . . is correct if income is defined as potential earning power, but it is not correct if income is defined as potential spending power for consumption."[1] He implies that the earning power definition is appropriate "if saving is for purposes of continuous accumulation," while the spending power definition is appropriate "if saving is for purposes of potential consumption."[2] In the absence of information about savers' motivations, apparently either definition can be justified. A taxable income index of relative taxpayer welfare defined to be (changes in) potential consumption spending power seems more intuitively appealing, perhaps because the economists' utility theory of consumer choice usually assumes that saving is for the purpose of future consumption rather than for its own sake.

Taxing capital gains caused by interest rate decreases may be justified by considering relative taxpayer burdens in a world with fixed price assets. If interest rates fall, the holder of a negotiable asset which continues to produce the same income and has a higher market value is better off in terms of earning power than the man whose fixed price asset (such as a savings account) now yields fewer dollars per year. Moreover,

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[1] Musgrave, Public Finance, p. 168.

[2] Ibid., p. 169.

the negotiable asset holder's greater relative taxpaying capacity is inadequately measured by his larger annual income, considering the increase in his consumption spending potential.[1]

Inflation. The argument that capital gains which reflect inflation should not be taxed because they are not income properly subject to income taxation supposes that relative taxpaying capacity arises only after the taxpayer has maintained a capital-value sufficient to provide a constant real income stream from that capital. But this condition is no more reasonable than its money income analogue. Grant that capital gains which reflect inflation are not "true" income -- this admission in no way indicates that such gains should be excluded from taxable income, even in principle. During inflationary periods, inflating assets generate more taxpaying ability than do non-inflating assets; a homeowner very well may be better off than his neighbor whose rent increases. Whether or not

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[1]Although Wallich argues that gains due to interest rate changes are "illusory" and not "true" income, he states that "in terms of equity, it is hard to argue that there is no increase in taxpaying capacity" from such gains; therefore he would tax them. ("Taxation of Capital Gains," pp. 137-139.) Yet if an asset's (expected) future income stream increases, he would exempt the resulting "pure" capital gain, measuring its recipient's increased taxpaying capacity only by the amount of the increased income. For Wallich, taxing a gain which capitalizes an (expected) larger income stream is inequitable since doing so involves double taxation: the larger future income will be taxed when it occurs (Ibid., pp. 139-140). If interest rates change, Wallich would measure relative taxpaying capacities by comparing income streams plus the capital gains (or minus the capital losses) which occur; if actual income streams change, he would measure relative taxpaying capacities by comparing income streams only, ignoring capital gains and losses. The logic of this viewpoint is not clear. If the double taxation argument applies, it ought to apply to both types of gain. See Turvey, pp. 183-184.

inflationary gains should be taxed must turn on taxation's impact in redressing the effects of inflation upon the distribution of real income.[1]

To review the effects of inflation on the distribution of income, consider four individuals: a debtor who has borrowed \$10,000 and spent it on consumption, an individual who has neither borrowed nor loaned, an owner with \$10,000 worth of property, and a creditor who has loaned \$10,000.[2]

Aside from the effects of interest rate movements inflation, of course, improves the position of the debtor and worsens the position of the creditor in terms of the real purchasing power of their asset positions. Also, assuming that wages rise as rapidly as consumer prices, inflation should have a neutral effect upon the position of the individual who has neither borrowed nor loaned. Similarly, assuming that property values rise as rapidly as other prices, inflation should have a neutral effect upon the position of the property owner. Both the individual who has neither borrowed nor loaned, and the property owner, will have the same purchasing power as before.

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[1]Whether the homeowner's position in fact improves relative to the renter's position depends upon their asset positions, as discussed below.

[2]The balance sheets of these simple cases are:

Debtor	
\$0	debt \$10000
	net worth -\$10000

"Neither"	
\$0	\$0

Owner	
property \$10000	net worth \$10000

Creditor	
loans \$10000	
	net worth \$10000

If taxable income including all capital gains and deducting all capital losses were measured consistently in real (deflated) terms,[1] it would most correctly assess inflation's redistribution of real income: it would levy on the debtor's gains, it would ignore the individual who has neither borrowed nor loaned and the property owner, and it would reduce the creditor's tax burden.[2]

However, complete and consistent measurement of all components of taxable income in real (deflated) terms is apparently impractical, because taxpayers in addition to reporting their income flows would have to report the details of their asset and liability positions. Unfortunately, measuring taxable income in money terms ignores the improvement in the debtor's position relative to the creditor, and also ignores the (smaller) improvement in the debtor's position relative to the individual who has neither borrowed nor loaned and to the property owner.

Any argument that the measurement of taxable income primarily in terms of money rather than real income should be relaxed by excluding

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[1] Musgrave suggests that deflation "by the prices of capital goods" is appropriate "if saving is for purposes of continuous accumulation," while deflation "by the prices of consumer goods" is appropriate "if saving is for purposes of potential consumption." Musgrave, Public Finance, p. 169. A third alternative would be to deflate by an overall price index including both capital and consumer goods, such as the Gross National Product implicit price deflator.

[2] Of course, at tax rates below 100 percent, taxation can only partially redress the redistributions of real income due to price level changes; taxing inflationary gains (and deducting inflationary losses) does not fully compensate inflation's losers. With regard to inflation, an ounce of prevention may be more feasible than a pound of compensation.

capital gains due to inflation from taxable income, implicitly compares the property owner either with the debtor or with the individual who has neither borrowed nor loaned. Aside from taxation, inflation (by favoring the debtor and having a neutral effect upon the property owner and upon the individual who has neither borrowed nor loaned) worsens the position of the property owner relative to the debtor, while leaving the property owner and the individual who has neither borrowed nor loaned in the same relative position. Taxing the property owner's inflationary gains will hurt him even more, relative to the debtor, and also will hurt his otherwise unchanged position relative to the individual who has neither borrowed nor loaned.[1] Therefore, according to this argument, inflationary gains should be tax exempt.[2]

The difficulty with this whole argument is that it overlooks comparing the property owner with the creditor. Aside from taxation, inflation (by having a neutral effect upon the property owner while harming the creditor) improves the property owner's position relative to the creditor. Hence the

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[1]The property owner's worsened relative position can not be justified as a progressive redistribution of income from the rich to the poor, because the property owner's income (say, $1,000 per year) may be substantially less than the non-property income (say, $30,000 per year) of the debtor or of the individual who has neither borrowed nor loaned. For example, compare an elderly retiree living off of a small investment in real property with an entertainment star.

[2]Wallich, "Taxation of Capital Gains," p. 137. Also see Seltzer, p. 287. For an argument that correcting capital gains and losses for ordinary price level increases is feasible and practical, see Cloe, "Capital Gains and the Changing Price Level" (1952).

property owner's inflationary gains should be taxed.[1]

Thus in a world in which taxable income is defined in money rather than in real terms, the equity of exempting or taxing inflationary capital gains in terms of relative tax burdens depends upon the illustrations considered, so that no clear rule emerges. Musgrave[2] concludes that

> It is clear enough as a matter of principle that all assets and liabilities should be adjusted for changes in price level and that accretion [taxable income] should be measured in real terms. Yet it is hardly possible in practice to carry out all these adjustments. With minor exceptions such as inventory evaluation, the income concept is, in effect, defined in money terms. In view of this, equity may be impaired rather than improved by piecemeal adjustments to allow for price-level change in selected parts of the system.

In other words, since taxable income is no more than an imperfect and somewhat arbitrary index of taxpaying capacity, if practicality (or ideology, for that matter) causes taxable income to be defined in money terms, then simple consistency in the use of this index requires that inflationary gains be taxed as just another component of taxable income.

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[1] In other words, since general price level changes do not affect the money value of fixed dollar claims (debts and loans) and therefore do not generate capital gains and losses on fixed dollar claims, price level change redistributions of real income from holders of fixed dollar claims (creditors) to holders of real dollar claims (property owners) will be included in a money income measurement of relative taxpaying capacity only if taxable income fully includes inflationary gains (and deducts deflationary losses) on real dollar claims. See Heller, "Investors' Decisions, Equity, and the Capital Gains Tax" (1955), p. 393; and Goffman, "The Taxation of Capital Gains: An Economic Analysis" (1962), p. 241.

For some intriguing capital gains taxation policy recommendations based on an initial assumption that inflationary gains should not be taxed, see Gottleib, "On Reform of the American Capital Gains Tax" (1958), pp. 338-350.

[2] Musgrave, Public Finance, p. 169. Also see pp. 334-335.

Furthermore, one might argue that in the absence of a clear rule in equity, simplicity should determine tax policy. In this case, the difficulty of distinguishing inflationary from non-inflationary gains argues for taxing both types of gains.

The belief that inflationary gains should not be taxed is widely accepted even by those favoring at least some tax on non-inflated gains. Congressional belief that taxing inflationary gains is inequitable has resulted in several discriminatory provisions pertaining to real estate gains. Capital gain on the sale of a taxpayer's principal residence is not taxable if the proceeds from the sale are reinvested in a new residence within one year before or after the date of sale. The taxpayer is allowed an unlimited number of untaxed transactions, but if before reaching age 65 he once sells a residence without reinvesting the proceeds in a new home, the capital gain previously accrued on all of his residences is taxable. However, gain on the first $20,000 of the proceeds from the sale of a house by a taxpayer 65 or older is tax-free, regardless of how the money is used, if the house was his principal residence for at least five of the preceding eight years.

Such provisions clearly discriminate against the homeowner who wants to sell, and rent a new home. They discriminate much more severely against the renter who owns no assets whose capital gains (if any) will be tax-free; inflation will certainly raise rents if it raises the cost of replacing an owned home. Of course, the apparent Congressional belief that all increases in a residence's value are due to a general inflation of housing costs is at least debatable; many residences have appreciated due to new industry, improvement of schools or construction of highways, or population influx.

Averaging gains and losses. A graduated tax rate structure taxes an income which fluctuates greatly from year to year more heavily than it taxes a non-fluctuating income, even if both income streams are equal on the average. Consequently, a major argument favoring special tax treatment of long-term capital gains has been that taxing a gain accrued over many years but realized in one year would be horizontally inequitable at ordinary income tax rates, since gains often would cause taxable income to fluctuate across rate brackets.

Present tax law's favorable treatment of capital gains is far more generous than needed to assure such horizontal equity between recipients of fluctuating capital gains and of nonfluctuating ordinary income. On the other hand, present law does nothing to provide horizontal equity between recipients of fluctuating and of nonfluctuating capital gains (if the fluctuations are over a graduated tax rate structure; that is if they do not fall entirely above the income level at which the 25 percent maximum capital gains tax rate becomes effective).

The income-bunching defense of special treatment for capital gains and losses is fallacious. Gains accrued over several years can easily be averaged, and special treatment is not an equitable substitute for averaging anyway.[1]

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[1] For a discussion of capital gain and loss averaging, see Goode, p. 199. For a general discussion of averaging devices applicable to all income or to capital gains and losses alone, see David, Alternative Approaches, pp. 166-183, 216-219; and Steger, "Averaging Income for Income Tax Purposes" (1959), I, pp. 599-607. For a specific averaging technique for capital gains and losses, see Folsom, "A Procedure for Averaging Capital Gains and Losses for Income Tax Purposes" (1969).

Equity Versus Special Treatment

Such attempts to defend the equity of present tax law's special favorable treatment of capital gains -- whether based upon assertions that, somehow, gains are not income, upon national income accounting concepts, upon beliefs that gains due to interest rate changes or due to inflation are "illusory," or upon special treatment as a substitute for averaging gains accrued over many years but realized in one year -- are not persuasive. These arguments against heavier capital gains taxation miss the central equity issue -- special treatment's effect on the relative distribution of taxpayers' burdens.

Special treatment of capital gains as generous as in present tax law inevitably assigns relative tax burdens capriciously, violating any reasonable index of taxpaying ability. The extremely unequal distribution of gains and losses among individuals with identical total incomes makes special treatment very inequitable horizontally. Partially taxed gains together with partially deductible losses are doubly unfair: many who enjoy the lightly taxed gains of a bull market get out in time and do not suffer the negligibly deductible losses of a crash. Also, particularly in a period of rising interest rates, some investors may invest for heavily taxed ordinary income but receive minimally deductible losses instead.[1]

Special treatment is also inequitable vertically if any degree of income tax progressivity is equitable, since special treatment disrupts income tax

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[1]For historical evidence, see Seltzer, pp. 115-128, 152-155. Also see Break, "On the Deductibility of Capital Losses Under the Federal Income Tax" (1952), pp. 214-229; David, Alternative Approaches, pp. 140-143, 223-224.

progressivity violently.[1] The higher the income bracket, the greater the proportion of lightly taxed capital gains. Even in the pre-income tax 1800's, when there was no tax advantage in receiving capital gains instead of ordinary income, they "played such an outstanding role in the creation of large fortunes as to suggest that they have been their main source."[2] In recent years, realized gains usually have run from 3 to 4 percent of total income (including gains) for all income classes, but 60 percent of incomes exceeding $500,000. Evidence indicates that special treatment of realized gains makes the federal income tax regressive for incomes above $200,000, and that exemption of unrealized gains transferred at death heightens that regressivity.[3]

Some may argue that with ordinary income tax rates ranging up to 70 percent, some progressivity reduction is desirable. But special capital gain and loss treatment reduces only <u>average</u> progressivity, violating the horizontal equity principle that financial equals should be taxed somewhat alike.

In the face of the available evidence of the enormity of the inequities caused by special treatment of capital gains and losses, allegations that

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[1] Okner, pp. 23-27.

[2] Seltzer, p. 6.

[3] U. S. Treasury Department, Internal Revenue Service, <u>Statistics of Income: Individual Income Tax Returns</u> for 1959-1962, Tables 15, 15, 16 and 10 respectively; Goode, pp. 194-195, 236, 326; and Musgrave, "How Progressive is the Income Tax?" (1959), III, p. 2227.

heavier gains taxation would be inequitable are almost heroic. But abstract philosophizing about the meaning of the word "income" does not yield a reasonable assignment of relative tax burdens. The taxpayer with gains is better off than the taxpayer without gains, who is better off than the taxpayer with losses, regardless of their source -- whether or not they are "illusory" or "unreal."

TAX LAW COMPLEXITY[1]

Perhaps the greatest disadvantage of special treatment of capital gains and losses is the real economic burden of the overwhelming complexity which special treatment has introduced into federal income tax law. The obvious results are government tax administration costs, taxpayer compliance costs, and resources privately misallocated by taxpayer attempts to avoid taxes. All these results have grave consequences for economic efficiency, national output, and economic growth.

Tax law complexity requires government to devote resources to devising, explaining, and publicizing statutory provisions, executive regulations and rulings, and judicial interpretations. It requires taxpayers to devote resources to examining, studying, and analyzing this whole body of tax law to apply it to their own affairs. It encourages taxpayers to ferret out legal arrangements of their affairs which will reduce their tax liabilities through tax avoidance techniques at first unsuspected by government. And it inspires taxpayers to

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[1] For additional discussion, see Folsom, The Full Inclusion, chapter III; David, Alternative Approaches, chapter II, and pp. 116-128.

corrupt political processes by pressuring lawmakers to change, qualify, expand, and nullify complicated details of statutes, regulations, and rulings, to facilitate their own tax avoidance techniques.

But society as a whole cannot avoid the burden of its collective consumption of resources by government. Each individual tax avoidance may be insignificant in size and unnoticed by the electorate, but the aggregate deeply erodes the income tax base, necessitating higher tax rates which would be noticed by the electorate. Legislative, executive, and judicial lawmakers strive to conserve the tax base by continually revising statutes and regulations, by handing out new Treasury rulings, and by "tightening" interpretations. These opposing efforts to erode and conserve the tax base continually alter the tax law -- making administration and compliance even more difficult and generating an enormous volume of tax litigation to clog the courts and divert them from more important responsibilities.

Resource misallocations due to tax law complexity are not limited to the large amounts of the economy's scarcest resource -- educated mental ability -- thus consumed by tax law administration and compliance. In striving to avoid taxes, the economy's private producers are seduced into otherwise uneconomic actions. If tax avoidance is easier in one industry than in another, the first industry's output will be relatively too large. If tax complexity generates uncertainty about the tax consequences of some real investments, real capital allocation becomes less a function of expected real costs and demands and more a function of the drafting quality of various statutes, regulations, rulings, and court decisions.

Defining Capital Gain and Loss

Special treatment of capital gains and losses complicates the whole body of legislative, executive, and judicial tax law for several reasons. Rigorously distinguishing capital gains from ordinary income is imperative if the taxpayer's natural desire to classify all receipts as capital gain instead of ordinary income is ever to be frustrated. Yet since a realized capital gain results from the sale of a stream of future ordinary income, the definitional problem is overwhelming. The law allowing, everyone would sell all rights to future ordinary income and convert that income to capital gain.

The definitional difficulty of taxing capital gains at lower rates than ordinary income has been likened to the definitional difficulty which would arise from taxing wages at lower rates than salaries.[1] For over forty years Congress has struggled -- sometimes valiantly -- to draw a clear line between capital gains and ordinary income, but the Internal Revenue Code does not contain one yet. Instead of a clear definition of capital gain and loss, we have an enormous volume of statutory, administrative, and judicial law classifying various sales of rights to future receipts as to whether they generate ordinary income or capital gains.

Apparently, income from personal services or business activity or from holding investment property should be ordinary income, while the profit from selling investment property should be capital gain. This vague distinction

[1]By Carl S. Shoup in Federal Tax Policy for Economic Growth and Stability (Hearings, 1955), p. 345.

has proved impossible to draft into law. Instead the statute states that capital gains and losses result from the "sale or exchange" of a "capital asset," defined to include any and all tangible and intangible property not specifically excluded by the statute. In general, the statute excludes land or depreciable property used,[1] or inventory or other property held for sale to customers, in the ordinary course of a trade or business. This residual definition is under constant attack either for excluding too much or too little. The taxpayer enjoying a gain argues that he has sold a nonexcluded (capital) asset; the taxpayer suffering a loss argues that it is fully deductible against ordinary income because he has sold an excluded (non-capital) asset.[2]

The statute provides explicitly that accounts receivable are not capital assets, and the courts hold that sale of a contractual right to either future or

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[1]Although not capital assets, land and depreciable real and personal property used in a trade or business can generate capital gains and ordinary losses. Gains on land (on which depreciation deductions cannot be taken) are capital gains. On depreciable real property such as a building, gains (over the book value) up to what the book value of the property would be under straight line depreciation are treated as a recovery of excessive accelerated depreciation deductions (which were taken against ordinary income) and are taxed as ordinary income; gains above the straight line book value are capital gains. On depreciable personal property, gains (over the book value) up to the original purchase price are treated as a recovery of ordinary income depreciation deductions and are taxed as ordinary income; gains above the original purchase price are capital gains. On all such property, losses are fully deductible from ordinary income.

[2]See Slitor, "Problems of Definition under the Capital Gains Tax" (1957), pp. 26-37. Also see Surrey, "Definitional Problems in Capital Gains Taxation" (1959); Eustace and Lyon, "Assignment of Income: Fruit and Tree as Irrigated by the P. G. Lake Case" (1962); "Notes: Distinguishing Ordinary Income from Capital Gain Where Rights to Future Income are Sold" (1956); Miller, "Capital Gains Taxation of the Fruits of Personal Effort: Before and Under the 1954 Code" (1954), and "The Capital Asset Concept: A Critique of Capital Gains Taxation" (1950). For attempts to write improved definitions see Silverstein, "The Capital Asset Definition" (1959); and Surrey and Warren, "The Income Tax Project of the American Law Institute" (1953).

overdue ordinary income is sale of a noncapital asset. Then does the consideration received in exchange for the sale or cancellation of some other contractual right (such as a lease, distributorship, or other right to use or buy or sell something) yield ordinary income or capital gain? To what extent must a taxpayer sever his connection with a property in order to have sold or exchanged it -- are oil royalties income or are they capital gains from the installment sale of a capital asset?

Just what is a customer, and when is a taxpayer in the ordinary course of his trade or business? Illustrative complexities here draw fine lines between being in the real estate business and investing in real estate, between routine business hedging and long-term speculating on organized commodity markets, between being in the lending business and investing in bonds. Furthermore, the existence of favored categories of receipts places apparently irresistible pressures on Congress to extend capital gain treatment, for example, to coal and timber royalties, stock options, lump-sum withdrawals from pension plans, and sales of patents (but not copyrights).

Converting Ordinary Income into Capital Gain

Special treatment makes possible a host of tax avoidance techniques which taxpayers may have only begun to discover, embrace, and battle for. The nonintegrated corporate and individual income tax structure has created innumerable opportunities for converting ordinary income into capital gains by accumulating ordinary income in a corporation (or partnership). Taxpayer ingenuity has required an incredibly complex income tax statute, including a penalty tax on "unreasonably" accumulated surplus and special levies on "personal" holding companies -- as distinguished from "bona fide" holding companies and financial intermediaries such as banks, savings institutions, and finance and insurance companies. Other provisions deal with "collapsible" corporations and partnerships, set up to transform profit on the sale of ordinary business inventory (such as a movie) from ordinary income into capital gain. Taxpayer attempts to distribute a corporation's retained earnings as capital gains instead of ordinary dividend income have generated a maze of arbitrary "rule of thumb" provisions dealing with liquidation distributions, security redemptions, and recapitalizations.

This large collection of provisions is almost incomprehensively complex. Yet at least according to ubiquitous tax advice literature currently available in vast quantities, ways to "convert" ordinary income into capital gain continue to abound.

Tax law complexities due to special treatment are directed primarily at smaller rather than large publicly held corporations. Yet even if this were not the case, complexity would inevitably fall with special severity upon small and new business.

> Every time a difficult provision is put forward, every time an obscure regulation is drafted, and every time we have a court decision of doubtful meaning, the smaller taxpayer suffers the most. . . . It is frequently impossible for the small taxpayer to make the outlays to fight his case, whereas the taxpayer with a great deal more [dollars] at stake can afford to pay for the various professional services required to present his case properly.[1]

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[1] Peloubet, "The Relation of Depreciation Policies to Business Concentration" (1950), pp. 60-61.

Since separate sections of the income tax law are highly interrelated, each complication spawns many others. The available evidence indicates that a draft of an income tax statute omitting special treatment of capital gains and losses and its attendant complications would be spectacularly short. Almost indisputably, special treatment does more to complicate the tax law than all other tax preferences combined. Its elimination is probably the largest step toward income tax law simplification which could be enacted.[1]

> A capital gain in the context of an income tax is a wholly arbitrary concept created exclusively by the tax law. . . . Both capital gains and ordinary income are improvements in economic position, and since the two cannot be distinguished on this -- their essential attribute -- the law must have recourse to other characteristics. These, however, will be matters of form and therefore often in the control of the taxpayers; and so the law feels compelled to erect rather elaborate barriers to restrict taxpayers' freedom to maneuver into the capital gain territory. Taxpayers naturally continue to explore for ways around these barriers, and as new holes become exploited, the law builds additional barriers. The whole process seems to be almost self-sustaining. In any event, it keeps the law well supplied with complexities. . . . There is bound to be great pressure to broaden the capital gains category, and since such classification is necessarily arbitrary, the demands will be difficult to resist. This has been the history of our capital gains provisions. . . . A capital gain is merely some form of income taxed at a bargain rate.[2]

The tax law's inability to distinguish clearly between capital gains and ordinary income inevitably confuses both tax administrator and taxpayer. The timid taxpayer overpays, the clever taxpayer underpays, and the unlucky taxpayer winds up in court. Unfortunately, the judge also may be confused.

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[1]See Stone, "A Comprehensive Income Tax Base for the U. S.?: Implications of the Report on the Royal Commission on Taxation"(1969), pp. 29-30.

[2]Blum, "A Handy Summary of the Capital Gains Arguments" (1957), pp. 262-263.

CAPITAL MOBILITY

Capital gains tax policy affects the mobility of financial capital in two major ways. First, special treatment of capital gains and losses distorts rates of return on alternative investments, and thus distorts the profitability of alternative real investment projects. Second, capital gains taxation disturbs securities prices in several ways, thus changing the ability of different firms to finance real investment in new plant and equipment. Consequently, heavier capital gains taxation on balance might--or might not -- significantly affect the real investment projects which do find financing and are carried out.[1]

Rates of return on financial investments, securities prices, and the resulting financial flows of money capital throughout the economy are not particularly important in themselves. The importance of financial flows is that money capital finances real investments in physical capital. Thus if taxation disrupts financial flows of money capital, it will affect the economy's choice of alternative real investments. Poor tax policy will misallocate economic resources.

Rates of Return on Alternative Investments

Present tax law's special favorable treatment of capital gains probably disrupts the mobility of financial capital most severely by distorting the after-tax rates of return on alternative financial and real investments. For example, limited deductibility of capital losses discourages high-risk investments. But more important is that capital gains tax rates range from

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[1] David, Alternative Approaches, pp. 193-197.

50 down to 36 percent of ordinary income tax rates. This tax rate differential disrupts financial capital movements in two ways.[1]

First, this differential can make an investment yielding a moderate before-taxes return as a capital gain more attractive than another investment yielding a much larger before-taxes return as ordinary income. Industries with the most deserving investment projects may be those least able to arrange a return in the form of capital gains. Historically, the motion picture production industry has been unusually successful in arranging its profits in the form of capital gains, yet there is little reason to suppose that this industry's real investments have been more productive than real investments elsewhere.

The second disruption of financial capital movements due to the gains-income income tax rate differential occurs because corporate retained earnings generate capital gains while dividends are ordinary income. A presently profitable industry whose investment opportunities are expected to generate only moderate future returns may retain most of its earnings, even though other industries have more productive investment opportunities.[2] Tax-conscious stockholders will prefer earnings retention unless the expected profitability of investments in other industries is great enough to compensate for the tax penalty on taking profits as ordinary dividend income.

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[1] David, "Economic Effects of the Capital Gains Tax" (1964), pp. 295-297, and "Evaluating Structural Changes in Capital Gains Taxation" (1965), pp. 646-649, and Alternative Approaches, pp. 247-257.

[2] See Brittain, Corporate Dividend Policy (1966).

Of course, to some extent firms in poor investment opportunity industries may diversify into other industries. But insofar as diversification occurs because of tax considerations, it must involve substantial real economic costs. The administrative inefficiencies of attempts to manage overly heterogeneous operations are notorious. Furthermore, uneconomic diversifications and mergers may impair workable competition.

Admittedly, heavier capital gains taxation might cause a larger dividend payout of corporate profits, which might encourage consumption spending, reduce saving, and thus retard economic growth. Also, even aside from its effects on dividends, heavier capital gains taxation probably would decrease individuals' private saving more than it would decrease consumption. In either case, an adjustment of other taxes or of fiscal and monetary policies could maintain the desired level of saving.[1]

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[1]A given level of real net national product can be achieved with either low or high levels of saving and investment and rates of economic growth, by using either "loose" fiscal and "tight" monetary policies to generate high interest rates, or "tight" fiscal and "loose" monetary policies to generate low interest rates. (Samuelson, Economics (1967), pp. 330-332, 589.) Despite this well known result of John R. Hicks' IS-LM analysis, recent capital gains tax literature has expressed much concern that heavier gains taxation would seriously reduce saving. See Wallich, "Taxation of Capital Gains," pp. 143-145. (For a critique of Wallich's multi-faceted argument, see Blum, "Taxation of Capital Gains . . . Some Observations" together with Wallich's "Rejoinder" (1965).) For a critique of Wallich's use of John J. Arena's econometric consumption function studies of the effect of realized and unrealized capital gains on consumer spending, to "show" that taxation of realized capital gains falls hardly at all upon consumption and almost entirely upon saving, see Folsom, "Capital Gains, Consumption, Capital Gains Taxes and the Supply of Saving" (1966), pp. 434-436; for a brief discussion of saving stimulants, see pp. 436-437. Also see Wallich's "Rejoinder" (1966). For further expression of concern about the effect of heavier gains taxation upon saving, see Slitor, "The Carter Proposals on Capital Gains: Economic Effects and Policy Implications for the United States" (1969), pp. 73-77; for a rebuttal see Harberger, "In Defense of Carter: A Personal Overview" (1969), pp. 167-172.

Securities Markets[1]

Capital gains taxation may affect the behavior of securities markets in several ways. It may change the demand to hold securities, the demand to acquire securities, the supply of existing securities offered for sale by securities holders, the supply of new securities issued by business firms, and also the short and long run dynamic processes by which securities markets react to short and long run disequilibrium.

The available literature pays some attention to the effect of capital gains taxation upon the demand -- to hold and to acquire -- securities, devotes the bulk of its attention to gains taxation's effect upon the supply of existing securities offered for sale by securities holders, gives little more than passing attention to gains taxation's effect upon the supply of new securities issued by business firms, and virtually ignores gains taxation's effect upon dynamic processes.

The effect of capital gains taxation upon securities markets to which the literature devotes the bulk of its attention, the effect upon the supply of existing securities offered for sale by securities holders, is usually called the "lock-in" effect. This label is used to describe both a temporary postponement effect and a permanent effect, both reducing the supply of existing securities offered for sale by securities holders.

Taxing long term capital gains (gains on assets held more than six months) at effective rates no more than half as high as those on short term gains constitutes a definite incentive to postpone realizations for as much

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[1]This section is a condensed version of the analysis presented in Folsom, "The Effect of Capital Gains Taxation upon Securities Markets: A Critical Review of the Theoretical Literature" (1968).

as six months.[1] Similarly, exempting accrued gains unrealized at death[2] discourages taxpayers desiring to maximize the value of their estates for their heirs from selling securities. Such incentives to postpone capital gains realizations certainly tend to reduce the supply of existing securities offered for sale by securities holders, and presumably have substantial effects upon the behavior of securities markets.

However, substantially higher long term capital gains tax rates together with taxing accrued capital gains at death would minimize capital gains taxation's temporary postponement effects. Therefore, the following discussion focuses upon gains taxation's "permanent" effect, assuming capital gains tax rates which do not decline (or which decline too far in the future to affect investors' current decisions and securities markets' current behavior). More precisely, the following discussion imagines a capital gains tax rate structure which eliminates the distinction between

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[1] This postponement effect apparently is substantial. For estimates of its magnitude, see Hinrichs, "An Empirical Measure of Investors' Responsiveness to Differentials in Capital Gains Tax Rates Among Income Groups" (1963); Folsom, "The Effect of Capital Gains Taxes upon Securities Markets, Gains Realizations, and Tax Revenues -- A Comment upon One of Harley H. Hinrichs' Empirical Studies" (1968); and Fredland, Gray, and Sunley, "The Six Month Holding Period for Capital Gains: An Empirical Analysis of its Effect on the Timing of Gains" (1968). Hinrichs presents data suggesting that reducing the differential between the short and long term capital gains tax rate by reducing the short term rate would alter the timing of security market transactions, stimulating short instead of long term realizations so much that tax revenues would increase.

[2] The untaxed unrealized capital gains of 1967 decedents have been estimated as $16.540 billion. See Bernard Okun, "The Taxation of Decedents' Unrealized Capital Gains" (1967), p. 385. For other estimates, see David, Alternative Approaches, pp. 60-61, 93-103, 242-246.

short and long term gains (for example by taxing long term gains at the same rates as short term gains) and which levies fully upon accrued capital gains at death.

Aside from postponement incentives, <u>any</u> capital gains taxation will discourage taxpayers from selling securities, and will have consequences for securities prices' behavior over time and relative to each other. Briefly, the argument is as follows: For administrative reasons, capital gains taxes become due and payable not as the capital gain accrues, but only when the asset is sold and the gain is realized. In a sense, the tax is a voluntary transfer tax, since it can be avoided by not selling the securities. Therefore, depending on expectations about future securities prices, the capital gains tax may discourage the taxpayer from selling his security -- he is "locked-in." Conversely, if his security has declined, the possibility of deducting his loss may encourage him to sell. In short, capital gains taxation distorts the "terms of trade" between the security the taxpayer is holding (with an accrued gain or loss) and other securities.

That capital gains taxation discourages a taxpayer from selling a security -- since doing so realizes a taxable capital gain -- is clear. Several models showing how the magnitude of this capital gains tax "lock-in" effect varies with the taxpayer's expectations about future prices of his security, about future prices of alternative securities, about securities prices after six months (so that the low long term rather than the high short term tax rate is applicable), about his own mortality (and the opportunity for his estate to escape gains taxes), and about future changes in effective tax rates, have been constructed and analyzed.[1]

Nevertheless, despite the existence of such models of the individual investor, and despite a large literature on the subject of capital gains taxation and the securities markets, models really adequate to analyze the consequences for the behavior of securities markets of this capital gains tax lock-in effect upon the supply of securities offered by individual investors have not been presented. The problem of capital gains taxation's effect upon securities markets has been discussed, but never rigorously enough to permit a clear judgment, or even a solid debate, as to whether gains taxation's consequences are serious. In the resulting absence of any consensus among economists about the major consequences of taxing capital gains, Congress -- largely in response to fears that heavier capital gains taxation would have "serious" consequences for the securities markets -- continues to tax capital gains (on assets held more than six months) at remarkably preferential rates, in comparison with the rates on ordinary income. The costs of this policy, in terms of equity considerations, tax law complexity, and inefficient allocations of real investment among alternative capital projects, may be substantial. The need for careful and convincing analysis confirming or denying Congressional fears about the securities market consequences of heavier capital gains taxation is very real and definite.

The commodity-tax analysis. The available analysis of the effect of capital gains taxation upon securities markets is a straightforward adaptation

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[1] For an example and bibliography, see Beazer, "Expected Income Changes and the Lock-In Effect of the Capital Gains Tax" (1966), pp. 308-318. Also see David, Alternative Approaches, pp. 128-140, 225.

of the usual demand and supply analysis of an excise tax on an ordinary commodity. This simple graphical comparative statics analysis (comparing securities market equilibrium positions under various alternative capital gains tax assumptions) assumes that although gains taxation decreases the demand for securities, the decrease in demand is relatively small because the buyer's future tax on his expected profits is distant and generally unknown. Gains taxation's primary effect is to shift the supply of securities offered for sale within an interval of time upward in a way which makes it steeper, because potential capital gains tax liabilities increase as securities prices rise.[1]

This analysis has discovered two major consequences of realized capital gains taxation for securities markets. First, gains taxation will distort the price of one security relative to that of another, thus altering the relative ease with which different firms can obtain new financing. Second, gains taxation will cause security market prices to fluctuate more widely than they otherwise would, which may generate cycles in real capital goods industries and interfere with the stability of long-run capital formation.

The first consequence of the shift in supply -- that relative security prices will be distorted -- occurs because the resulting reduction in sales

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[1]The original presentation of this analysis was by Somers, "An Economic Analysis of the Capital Gains Tax"(1948). Later discussions have criticized, amended, and expanded Somers' analysis, but have accepted his graphical comparative statics single market methodology. See Folsom, "The Effect of Capital Gains Taxation upon Securities Markets: A Critical Review of the Theoretical Literature" (1968).

is greater for appreciated securities. Thus gains taxation, by disproportionately reducing sales of appreciated securities, keeps their prices up, and simultaneously reduces demand for unappreciated securities and keeps their prices down. Even if the old appreciated securities are those of firms in relatively obsolete or stagnant industries which have "seen their day" and now are faced by relatively unattractive opportunities for physical investment, while the unappreciated securities are those of firms in new rapidly growing industries which are faced by relatively very productive opportunities for physical investment, gains taxation will deter the holders of securities in the old industries from selling and purchasing securities in the new industries.

The heavier capital gains taxation is, the higher the prices of old industry securities will be, and the lower the prices of new industry securities will be. As a result of such distortion of security prices, firms in the old industries with the least attractive investment opportunities will be able to raise financial capital more easily, and firms in the new industries with the most productive investment opportunities will be able to raise financial capital less easily than if capital gains taxation were lower or nonexistent.

Thus, by distorting relative security prices, heavier capital gains taxation may distort financial flows and misallocate the resources available for physical investment, for example by reducing the "cost of capital" for old previously successful firms (whose securities will have appreciated) and thereby increasing the cost of capital for new ventures.[1]

The second consequence of the shift in supply -- that price fluctuations over time will be larger -- occurs because with a steeper supply curve, shifts in demand will have a larger effect on prices and a smaller effect on transactions volume. Insofar as heavier gains taxation would make securities prices fluctuate more widely and move more closely with the business cycle, heavier gains taxation would reduce the cost of capital while capital goods industries are already booming, and raise it while they are retrenching, thus magnifying the instability of these industries and destabilizing the economy as a whole.

Critique of the commodity-tax analysis. In what circumstances, and to what extent, does capital gains taxation really distort relative security prices in ways which make it more difficult for new ventures to find financing? And does it really magnify securities market fluctuations? Considering not only the lock-in effect upon the supply of securities but also considering gains taxation's effect upon the demand for securities and upon dynamic processes, the foregoing discussion is not entirely convincing.

The effect of capital gains taxation upon relative security prices must depend not only upon supply but also upon demand considerations, and

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[1]This implication of the argument is by Martin David, "Economic Effects of the Capital Gains Tax," pp. 293, 294. But David notes that the lock-in effect, even if large, will be unimportant insofar as new saving, instead of "trickling down" to new issues (flowing first to the purchase of old appreciated blue chips -- whose holders are locked-in -- which must be sold to finance new issues) flows directly to the new issues. Somers' rebuttal probably would be that because of capital gains taxation's distortion of relative security prices, the funds flowing to new issues will tend to flow to new issues of old firms, rather than to new issues of new firms.

it is at least possible that capital gains taxation's demand effects will tend to offset its supply effects enough that on balance prices change little. For example, gains taxation may tend to shift each security's demand and supply leftward to the same extent. Also, assuming that the demand and supply for each security are functions not only of its own price but also of other security prices so that changes in one price affect demand and supply for many different securities, a multi-market analysis may show that gains taxation could cause market interactions which tend to be self-cancelling. Such offsetting may be improbable, but the bare possibility suggests that simple speculations as to the effects of gains taxation upon the relative security prices of different kinds of firms may be misleading.

Similarly, gains taxation's influence upon fluctuations in security market prices over time will depend not only upon the steepness of the supply curve, but also upon gains taxation's effect upon the demand curve. For example, the "capital effect" of capital gains tax liabilities on realized gains will reduce the funds available for reinvestment and thus decrease demand; loss deductibility, by reducing taxpayers' other tax liabilities, will increase the funds available for reinvestment and thus increase demand.[1] Considering this capital effect, it is not clear that the effect of gains taxation upon demand will be small relative to its effect upon supply, or that gains taxation's primary impact upon securities markets will be via its effect upon supply. Given the capital effect, taxation of realized capital gains may moderate the rise of a bull market -- or accentuate the fall of a bear market. Deduction of realized capital losses may

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[1]Gemmill, "The Effect of the Capital Gains Tax on Asset Prices" (1953), pp. 298-299.

stimulate a bull market -- or prop a bear market. Gains taxation may either moderate or magnify market fluctuations.

More fundamental, methodological, criticisms of the commodity-tax analysis of capital gains taxation's effect upon securities markets are as follows. First, this analysis (and also the literature criticizing it) typically ignores the distinction between stocks and flows, and therefore it relies upon conceptions of equilibrium and disequilibrium which are incomplete and inadequate. Second, conclusions about gains taxation's effects upon the behaviour of securities markets over time are dynamic in nature, and really do not follow from the comparative statics analysis used. A more adequate theoretical model of capital gains taxation's effects upon securities markets -- a multi-market model which devotes sufficient attention to demand as well as to supply, which distinguishes between stocks and flows, and which considers dynamic processes in the short and long run -- is clearly needed.

The need for a stock-flow analysis.[1] The commodity-tax analysis of capital gains taxation focuses exclusively on "investment" demand and supply: the demands to acquire existing securities within some interval of time, and the offers to sell existing securities within some interval of time. This model is in complete equilibrium whenever it is in investment equilibrium, that is, whenever the quantity of acquisitions demanded per time interval by

[1]The following discussion is based upon the stock-flow models of Bushaw and Clower, Introduction to Mathematical Economics (1957), chapter II.

those desiring additional holdings equals the quantity of offerings supplied per time interval by those desiring fewer holdings.

The difficulty with this model applied to a durable item such as a security is that investment equilibrium is a short run concept, because as soon as securities have flowed from those desiring fewer holdings to those desiring additional holdings, the flow of securities will cease. In addition to investment demand and supply and investment equilibrium, a model of a market for a durable item should also include stock demand (the total "reservation" demand to hold a stock of the item at a point in time, by those holding them and by those not holding them), stock supply (the total existing stock of securities available at a point in time to be held by anyone), and the intermediate run concept of stock equilibrium (in which stock demand equals stock supply). Investment demand and supply are derived from the stock demands of those whose holdings are greater than they desire and those whose holdings are less than they desire. Since investment demand and supply depend upon stock demand and supply, the short run prices set in investment equilibrium must depend upon stock demand and supply. Prices in the intermediate run stock equilibrium depend not upon transitory market run current investment flows between demanders and suppliers of existing securities, but rather upon the stock demands of everyone in the market.

A securities market model which excludes stock demand and supply, excludes the basic determinants of market run investment equilibrium and can be used only for a preliminary superficial analysis of the effect of gains taxation upon investment equilibrium prices. Such a model cannot analyse the effect of gains taxation upon stock equilibrium prices at all.

In addition to investment demand and supply and stock demand and supply, a complete analysis of the market for a durable requires a third set of concepts: flow demand (the demand to consume the commodity within some interval of time), flow supply (the supply of new output within some interval of time), and long run flow equilibrium (in which consumption equals production). For a securities market, there will not be any consumption of or demand to consume securities, but the supply of new securities -- the quantity of additional securities issued -- may be positive (if firms are issuing new securities) or negative (if firms are retiring securities). A securities market is in flow equilibrium only if securities are neither being issued nor retired. If a market is not in flow equilibrium, the stock supply available to hold will change.

Although in an intermediate run analysis changes in the stock of securities can perhaps be disregarded, some attention should be paid to such flows, since they do occur -- their occurrence controls the long run equilibrium prices of securities, and in fact their occurrence is the primary economic justification for the existence of securities markets. Securities market models which exclude flow demand and supply are not really capable of assessing the effect of capital gains taxation upon issues of new securities.

<u>The need for a dynamic analysis</u>. Implicit in the foregoing discussion

of the need for a stock-flow analysis of the effect of capital gains taxation upon securities markets is the assumption that the analysis would have to be dynamic. Any discussion of the effect of short run equilibrium prices upon stock demand and thus upon investment demand and supply, or upon flow demand and supply and thus upon stock supply, inevitably entails interactions which inextricably involve time in an essential way. The point of a stock-flow analysis is to analyse the effects of stocks carried over from one time period to another upon subsequent economic activity.

Aside from the idea that a stock-flow analysis inevitably involves dynamics, the effect of capital gains taxation upon securities markets is a problem which needs to be approached with a dynamic model. First, although the effect of gains taxation upon relative security prices may be construed narrowly to deal only with relative prices in equilibrium, a more useful analysis would deal with gains taxation's effect upon relative security prices in disequilibrium as well as in equilibrium. Much, perhaps most, new financing occurs while financial markets are far away from long-run equilibrium. Second, the literature has already argued that gains taxation magnifies fluctuations in security prices, and this conclusion is inevitably dynamic in the sense that it involves the effect of gains taxation upon the behavior of security prices over time. Fluctuations in security market prices may occur not only or even primarily because of changes in the market's equilibrium position, but because of its disequilibrium movements. Also, insofar as movements in security prices are reactions to disequilibrium conditions, the dynamic effect of gains taxation upon price movements will depend upon the effect of gains taxation upon the way in which the market reacts to disequilibrium -- for example, depending upon the effect of gains taxation upon speculation about future prices, and the effect of speculation upon price movements.

Nevertheless, although the available analyses of capital gains taxation's consequences for security markets -- relative prices and fluctuations over time -- are grossly inadequate, taxation of realized capital gains undoubtedly has some effects upon securities markets, and these effects may interfere with the mobility of financial capital.

Empirical evidence. The severity of capital gains taxation's effects upon security markets is an empirical question. Unfortunately the available statistical estimates are conflicting and contradictory, perhaps because they rest upon an inadequate theoretical foundation.

New York Stock Exchange studies have used "depth interviews" to generate evidence of a very large capital gains tax "lock-in" effect upon the supply of securities offered for sale: a lower long term capital gains tax rate would "unlock" such a large volume of capital gains that tax revenue would *in*crease substantially.[1]

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[1] See the New York Stock Exchange studies in the list of references, below.

U. S. Treasury figures show a much smaller lock-in effect; a lower long-term capital gains tax rate would decrease tax revenue.[1] The Treasury has not publicly explained how it obtained its estimate, although private discussions and correspondence indicate that a regression analysis plus a substantial amount of judgment was involved.

The difference between the Exchange and Treasury results is at least partially explainable. The Exchange estimates are for the first year after the gains tax rate cut (although the Exchange's data cause it to "expect lower capital gains tax rates to lead to permanently higher levels of sales

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[1] U. S. President, 1961-1963 (Kennedy), President's 1963 Tax Message, Hearings, pp. 71, 365, 386, 708; U. S. Congress, House Committee on Ways and Means, Legislative History of H. R. 8363, 88th Congress, The Revenue Act of 1964, Public Law 88-272, Part I, pp. 184, 235. The Treasury estimated that President Kennedy's proposals to reduce individuals' long-term capital gains tax rates (by reducing the included amount from 50 to 30 percent and by reducing ordinary income tax rates) would reduce tax revenue by $310 million, while taxing capital gains at death ("constructive realization") would increase tax revenue by $750 million; on balance capital gains tax revenue would increase. Since the New York Stock Exchange did not consider constructive realization, a comparison of its estimates with the Treasury's estimates should include only the effect of reducing gains tax rates. David, however, apparently has confused the "on balance" effect of lower rates and constructive realization with the effect of lower rates alone; he incorrectly states that both the New York Stock Exchange and the Treasury have estimated that lower gains tax rates would increase gains tax revenue. (Alternative Approaches, pp. 199-200, particularly note 3.) David mentions an expected $450 million tax revenue increase due to increased asset turnover, but this is turnover induced by constructive realization, according to correspondence from Thomas Lee Smith (3 August 1966) and Thomas R. Lusk (July 1966), Office of Tax Analysis, Office of the Secretary of the Treasury. This correspondence cited Exhibit 46-A, particularly items 1 and 5, in TAX TABLES AND CHARTS, PRINT NO. 8 (as of September 9, 1963), prepared by the Treasury Department and the Staff, Joint Committee on Internal Revenue Taxation, for use of THE COMMITTEE ON WAYS AND MEANS in its EXECUTIVE CONSIDERATION OF THE PRESIDENT'S 1963 TAX MESSAGE, pp. 209-211.

and revenues"[1]); the Treasury's estimate is expected revenue "per year."

Other empirical studies of the effect of capital gains taxation upon securities markets do not bear upon the revenue effect of changing the long-term tax rate,[2] despite statements implying the contrary. Rather they present evidence dealing with the postponement incentive created by the differential between short and long-term capital gains tax rates.[3]

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[1]New York Stock Exchange (1965, p. 6; also see mimeographed 1960, p. 5; and printed 1960, pp. 2, 6.) According to the Exchange's interviews, lower long-term capital gains tax rates would cause the most dramatic increases in expected realizations for securities in a selected list (the same in 1965 as in 1960) of "twelve . . . widely-held . . . investment-grade quality stocks" representing "more than 20% of the market value of stocks traded on the New York Stock Exchange" and whose "combined turnover ratio was well under half of that for all other New York Stock Exchange issues." (The quotations are from pp. 5-6 of the printed 1960 statement, but they apparently apply to 1964-1965 as well. See mimeographed 1965, pp. 3-4, 8; mimeographed 1960, pp. 2, 6.) Data on these twelve securities may overestimate the effect of a gains tax cut on transactions volume in other securities more frequently traded even at present "high" gains tax rates. In 1965, each investor was asked about all securities in his portfolio (mimeographed 1965, pp. 7, 8), which was an improvement over the 1960 methodology. In 1960,investors holding any of the twelve issues were asked only about those issues; data on other securities were obtained only from investors holding none of the twelve issues (mimeographed 1960, pp. 1, 3). In 1960 "data from the two groups of stocks [the twelve issues, and other securities] could not be combined into a projection for the market as a whole." (mimeographed 1960, p. 3).

[2]See the references listed in note 1, page 38.

[3]Independently of his postponement incentive data, Hinricks opines that, aside from the opportunity to escape gains taxes at death ("the ultimate ploy in tax avoidance"), the lock-in due to the long-term capital gains tax rate is "not much." Hinrichs, "An Empirical Measure," p. 229.

SUMMARY AND RECOMMENDATIONS

Tax equity requires a reasonable relative distribution of tax burdens, not arbitrary adherence to some artificial definition of "income." If total income including consumption and saving measures the citizenry's relative taxpaying ability, then taxable income should include all realized capital gains -- whether spent on consumption or saved by remaining invested, and even if "unreal" or "illusory" due to inflation or interest rate changes. Those who realize capital gains of any kind are better off than those who receive no gains or who realize losses. Because gains and losses are not received in proportion to income but are distributed capriciously among taxpayers with equal incomes and are most important for taxpayers with the largest incomes, special treatment is an enormous disruption of the horizontal and vertical equity of an income tax designed to assign relative tax burdens fairly. To argue persuasively that special treatment is equitable is very difficult.

In evaluating the resource allocation effects of capital gains tax policy, special treatment's disadvantages and heavier capital gains taxation's advantages must be compared with heavier gains taxation's disadvantages.

Perhaps most harmful to the economy's overall efficiency and to the quality of its real investment allocations is the real economic burden of the overwhelming tax law complexity which special treatment of capital gains and losses has introduced into federal income tax law. Since capital gains and losses are not readily distinguished from ordinary gains and losses, special treatment inevitably creates legal chaos -- expensive for taxpayer, government, and the economy as a whole.

Tax law complexity is not the only disadvantage of special treatment. Limited capital loss deductibility discourages high risk investments. Favorable tax treatment of capital gains distorts after-tax rates of return on alternative financial and real investments, subsidizing investment projects in industries able to arrange returns in the form of capital gains, and penalizing movements of funds between firms as ordinary dividend income. It thus encourages funds to move to new investments within rather than between firms, and stimulates uneconomic diversifications, mergers, and industrial concentration. Even with regard to securities markets, heavier gains taxation could reduce or even eliminate some interferences with capital mobility now caused by taxing gains at lower rates than ordinary income. Exempting from tax all gains on assets held until death certainly involves a postponement type of lock-in effect; so does taxing long-term gains at lower rates than short-term gains.

The argument that heavier capital gains taxation would impair the quality of real investment in new physical capital by hampering transactions on financial markets, distorting relative security prices, magnifying security prices' fluctuations, and thereby disrupting money flows, is fairly persuasive. However, the consequences of the lock-in effect for the behavior of security prices have never been analyzed at all adequately. And empirical evidence on the magnitude of this lock-in effect is scarce, poorly documented, contradictory, and consequently inconclusive. The question here is: What are the effects of capital gains taxation upon securities markets, and what are their magnitudes? Valid answers to part two of this question, empirical estimation, must wait upon conceptual understanding of the answer to part one.

That Congress would be willing to tax capital gains as ordinary income[1] in one fell swoop is not likely. But a number of more modest steps could reduce the differential between ordinary income and capital gains tax treatment. Special favorable tax treatment of capital gains can be attacked from two directions: raising the effective capital gains tax rates, and reducing the types of receipts qualifying for capital gain treatment. These changes, particularly if advocated strongly by the Administration, could receive serious Congressional consideration.

Raising Effective Capital Gains Tax Rates

To vastly improve the equity of the income tax structure and to minimize capital gains taxation's lock-in effect, the highest priority capital gains tax reform should be to tax capital gains at death. Similarly, gifts of appreciated assets should be subject to capital gains tax by the donor. (Under present law, the recipient of a gift, if he sells it, measures his gain from the donor's original cost or "basis." Therefore, gift of an asset does not completely avoid gains tax, but the gains tax may be reduced if the recipient is in a lower tax bracket. A loss is measured from the donor's original cost, or else from the gift's market value on the date of the gift, whichever is lower.)

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[1] For the income tax law changes necessary to tax capital gains as ordinary income, see Folsom, Full Inclusion, Chapter IV; David, Alternative Approaches, pp. 12-18, 33-35.

The appraisals required for constructive realization of unrealized capital gains and losses transferred by bequest or gift, unlike appraisals for estate and inheritance taxes, would tend to be somewhat "self-correcting" because they would furnish the heirs' cost bases. Excessive appraisals would reduce heirs' later gains tax liabilities, and vice versa. For the benefit of illiquid estates, gains taxes levied on any estate could be payable in installments over a substantial number of years.[1] If the combined capital gains and other death tax liabilities would be too large, the proper remedy is to reduce or eliminate the other death levies rather than to continue the inequities and economic distortions due to complete exemption from income tax of accrued gains held until death. Of course, gains are not inevitable. An estate's net loss could be allocated to each heir in proportion to his share of the total estate, either increasing the cost basis of his inherited assets (other than cash) or providing him an ordinary income tax deduction.[2]

Repeal of the ordinary income tax deduction for nonbusiness interest payments would further diminish the lock-in effect, since the interest deduction encourages taxpayers to borrow on appreciated assets and to hold them until death, or until the asset is given away.[3]

The six months short term holding period could be lengthened to one

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[1] See Harriss, "Economic Effects of Estate and Gift Taxation" (1955), pp. 860-862.

[2] For a discussion of taxing accrued capital gains at death, see David, Alternative Approaches, pp. 145-164, 213-214, 220-223.

[3] For a discussion, see Simons, Federal Tax Reform (1950), pp. 61-68.

year or even longer, although doing so might increase the short run lock-in effect upon securities markets. The 25 percent maximum long-term capital gains tax rate could be abolished, so that all taxpayers simply included half of their net long-term gain in ordinary income. If this were done, losses could be made more deductible, by treating them symmetrically with gains -- allowing taxpayers to deduct 50 percent of a year's net capital loss from ordinary income. Eventually, this taxable long-term gain and deductible loss proportion could be raised, to 60 percent or even higher, particularly if such high rates were accompanied by averaging the taxed gain and deductible loss on assets held more than one year.[1]

Narrowing the Applicability of Capital Gain Treatment

Some steps to simplify the tax law by reducing the types of receipts qualifying as capital gains would be to repeal capital gains treatment for stock options, lump-sum withdrawals from pension plans, coal and timber royalties, and gains on land and depreciable property used in a trade or business. A more significant step would be to abolish completely the distinction between capital gain and loss and ordinary income and loss

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[1]Recent Canadian tax proposals have included converting the corporate income tax into a personal income tax "withholding" levy, taxing each stockholder not only on the dividends he receives but also on his share of the corporation's retained earnings, and taxing realized capital gains as ordinary income. However, each taxpayer would reduce his gain (or increase his loss) by his (already taxed) share of the corporation's retained earnings; thus only "goodwill" realized capital gains over and above the capital gains due to earnings retention would be taxed when selling a security. See Break, "Integration of the Corporate and Personal Income Taxes" (1969).

for corporations.[1]

The most controversial narrowing of capital gain treatment would be to fully tax all gains on residences and other real estate as ordinary income, making all capital losses on real estate fully deductible. (Under present law, a loss on one's residence does not even qualify as a capital loss. It is not deductible against anything, on the grounds that it is a personal living expense. Yet loss on a residence may stem from neighborhood deterioration, population outflow, or an excessive building boom -- none of which are personal living expense or avoidable by the individual.) Gains and losses on assets held more than one year should be averaged. Fully taxing real estate gains as ordinary income should affect financial markets, financial capital movements, and incentives to supply venture capital to risky new growth businesses, only minimally.[2]

Significantly heavier effective tax rates on capital gains, together with improved deductibility for capital losses, would improve the equity of the tax structure dramatically. Reducing the types of receipts qualifying as capital gains would simplify the tax structure drastically. Whether

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[1] Despite his vigorous opposition to heavier capital gains taxation under the personal income tax, this recommendation for corporate income tax simplification is by Dan Throop Smith. He adds the proviso that the highest corporate income tax rate be reduced below 50 percent. (Smith, pp. 203-205.) Since Smith's 1961 recommendation, the Revenue Act of 1964 reduced this rate from 52 to 48 percent, and the 10 percent surtax has raised it to 52.8 percent.

[2] This point is made by Richard A. Musgrave, "Effects of Tax Policy on Private Capital Formation" (1963), pp. 105-106.

heavier capital gains taxation on balance would improve or impair the mobility of financial capital and the allocation of real investment is really indeterminate. But at least the costs of special treatment are too serious to ignore. "It is time for Congress to quit this ludicrous business of dipping deeply into great incomes with a sieve."[1]

[1]Henry Simons, Personal Income Taxation (1938), p. 219.

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13. ABSTRACT

Unless tax policy is evaluated not only from a short-run macroeconomic fiscal policy standpoint but also from a longer-run microeconomic policy standpoint that considers taxation's effects upon equity and resource allocation efficiency, federal taxation's unnecessary excess burden will become no lighter and may grow heavier. This paper attempts to redress the balance of the current federal personal and corporate income tax reform discussion, which has paid minimal attention to the case for heavier capital gains taxation. It reviews the capital gains tax policy literature, argues that present tax law's special treatment of capital gains and losses (compared with its treatment of ordinary income and loss) is not justified, and offers specific recommendations for taxing capital gains more heavily.

Special treatment is horizontally and vertically inequitable. It is a major cause of income tax law complexity. And it misallocates the resources invested in new physical capital, by distorting taxpayers' financial decisions and disrupting movements of financial capital, more seriously than heavier capital gains taxation would. Capital gains tax reform should decrease the differential between the effective tax rates on capital gains and ordinary income, and narrow the legal definition of capital assets qualifying for special treatment.

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